Internal Revenue Service

# memorandum

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Br4:RBWeinstock

date: APR 18 1988

to: District Counsel, Des Moines
Attn. Rogelio A. Villageliu

from: Director, Tax Litigation Division

subject: [redacted]

This is in response to your request for technical advice regarding whether the Service should concede this case in light of Commissioner Gibbs recent letter to Senator Chiles.

## ISSUE

Whether amounts received by a doctor during residency at a teaching hospital are excludable from gross income as a scholarship or fellowship under I.R.C. § 117.

## BACKGROUND

Petitioner [redacted] was a resident physician at [redacted] (the Center) for the years [redacted] and [redacted]. The Center issued Forms W-2 showing wages of $[redacted] in the year [redacted] and of $[redacted] in the year [redacted]. The taxpayer excluded $[redacted] in each year under I.R.C. § 117(b)(2) which the District Director disallowed.

Petitioner began a residency in internal medicine at the Center in [redacted]. Petitioner signed a contract agreeing to meet his responsibilities in the position, and abide by the Center's policies and procedures. Outside work and leisure activity are not to detract from performance as a resident physician, and no outside clinical work is to be performed without approval. The amount of the stipend increases by approximately $[redacted] per year. The Center provides malpractice liability insurance, and offers the same options of health and dental insurance that is available to full-time employees. Payroll deductions are also available for optional universal life insurance and tax sheltered annuities. Other benefits include 3 hours sick leave per pay period, workmen's compensation, drug discounts, health service, maternity leave, 3 weeks paid vacation per year, a medical meeting allowance, free meals, three free uniforms, uniform laundering and YMCA/YWCA membership discounts.

ANALYSIS

For the years at issue I.R.C. § 117(a)(1) provided that gross income does not include any amount received as a scholarship at an educational organization described in I.R.C. § 170(b)(1)(A)(ii) or as a fellowship grant. For individuals who were not candidates for a degree, I.R.C. § 117(b)(2) limited the amount of the exclusion to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year except no exclusion was allowed after the recipient has been entitled to exclude under this section for a period of 36 months.

Treas. Reg. § 1.117-3(c) defines a fellowship grant as "an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research." Whether a particular payment satisfies the general definition depends upon the nature of the activities carried on by the recipient, and by the purpose of the grantor in making the payment. If a payment represents compensation for employment services or services which are subject to the supervision of the grantor, it is not excludable as a fellowship grant.

Rev. Rul. 57-386, 1957-2 C.B.107 held that stipends received by interns and resident physicians at a medical training hospital, in order to complete or receive specialized training, constitute compensation for services rendered, and such stipends are not excludable from gross income under I.R.C § 117. This ruling was amplified by Rev. Rul. 72-469, 1972-2 C.B. 79.

Rev. Rul 75-280, 1975-2 C.B. 47, held that stipends received by graduate students who performed certain research services would be regarded as a scholarship or fellowship grant and not be regarded as part-time employment where the taxpayer was (1) a candidate for a degree at an educational institution, (2) the taxpayer performed research, training, or other services for the institution that satisfied then existing specifically stated requirements for the degree, and (3) equivalent services were required of all candidates for the degree.

Where the three conditions were met, Rev. Rul. 75-280 stated that the Internal Revenue Service would assume that the amounts paid were for the primary purpose of furthering the education and training of recipients in their individual capacity. The ruling stated however that the Service will not assume the primary purpose test was satisfied to the extent (1) the taxpayer performs services in excess of those required for the degree; (2) the taxpayer performs research, teaching or other services for a party other than the educational institution; (3) the grant is made because of past services or conditioned on performance of future services; or (4) the degree requirements, or the nature and extent of the work that is approved as satisfying the degree

requirements, are not reasonably appropriate to the particular degree.

As the appeals statement that you submitted to our office indicates, the Service has prevailed in most litigation involving resident doctors who have attempted to have their compensation treated as a tax-free scholarship or fellowship under § 117. Yarlott v. Commissioner, 717 F.2d 439 (1983); Rockswold v. United States, 620 F.2d 166 (8th Cir. 1980). But see, Mizell v. United States, 663 F.2d 772 (8th Cir. 1981). Additionally, in a footnote in Nino v. Commissioner, T.C. Memo. 1980-204, the Tax Court observed that Rev. Rul. 75-280 (and I.R.C. § 117(b)) applies to the rendering of services that are in the nature of part-time employment and is not applicable to situations such as a medical residency which involves services in the nature of full-time employment.

Notwithstanding this favorable case law, a litigation guideline memorandum was recently issued stating that Rev. Rul. 75-280 is to be followed. This is consistent with Commissioner Gibbs recent response to Senator Chiles of Florida who had inquired about a number of stipend cases involving graduate students. The Service also issued a news release on March 30 (IR-88-65) stating that if the three part test of Rev. Rul. 75-280 is met, the Service will assume that the amount of a stipend was for the primary purpose of furthering the taxpayer's education or training and is excludable from gross income. We have attached a copy of the news release for your information.

In connection with your case, you can still argue that the petitioner fails to satisfy Rev Rul. 75-280 on several grounds. As stated in the Nino case, the ruling and section 117(b) applies only to situations involving services in the nature of part-time employment. 1/ Additionally, petitioner does not fall within Rev. Rul 75-280 because he was not a candidate for a degree. While it is true that after completion of the residency program, the petitioner received some sort of certificate, it can be asserted that this certificate is not a degree.

In Schwerm v. Commissioner, T.C. Memo. 1986-16, after finding that the taxpayer's stipend from an internship program

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1/ Subsequent to orally advising you that petitioner has not satisfied Rev. Rul 75-280, we attended a conference with Bryan Slone, Assistant to the Commissioner (Legislative Liaison). Mr. Slone said he was not sure whether it would be permissible for you to argue that petitioner has not satisfied Rev. Rul. 75-280 on the theory that Rev. Rul. 75-280 covers only part-time employees. Mr. Slone stated that he would confer with Commissioner Gibbs on the question. We will orally advise you as soon as we are advised by Mr. Slone.

was a scholarship, the Tax Court held that the amount excludable was subject to the limitations contained in I.R.C. § 117(b)(2)(B). While the taxpayer received a certificate, the Tax Court held that the certificate was not equivalent to a degree, but rather was a license to engage in particular employment and was issued by a regulatory licensing agency, not an educational organization. With respect to resident physicians the Tax Court has observed that, "this and other courts have consistently found as fact that resident physicians in similar programs [receiving a certificate after completion of the residency program] are not candidates for a degree within the meaning of section 117(b)." Bergeron v. Commissioner, T.C. Memo. 1972-248, 31 T.C.M. 1226, 1231. But see, Rev. Rul. 58-338, 1958-2 C.B. 54 (Accredited school of nursing's certificate qualifies as an educational degree for purposes of section 117).

Furthermore, the Center does not qualify as an educational organization within the meaning of I.R.C. §§ 117(a)(1)(A) and 170(b)(1)(A)(ii) since its primary purpose is the rendering of hospital and medical care and not the rendering of formal instruction. Additionally, the Center does not normally maintain a regular faculty and curriculum with a regularly enrolled body of pupils or students in attendance at the place where its educational activities are carried on. I.R.C. § 170(b)(1)(A)(ii) and Treas. Reg. § 1.170A-9,(b). The Tax Court held in Hanson v. Commissioner, T.C. Memo 1979-108, that none of the hospitals or clinics at which the taxpayer worked while a resident of the program qualified as an educational institution. The primary purpose of the hospitals and clinic was to care and heal the sick, not educate students. The fact that each resident received some amount of didactic instruction and was required to attend some conferences did not convert a hospital into an educational institution. Accord, Bharmota v. Commissioner, T.C. Memo. 1979-28.

In summary, Rev. Rul. 75-280 should be applied to the facts of this case and we should argue that the petitioner fails to satisfy the three-part test of the ruling. Therefore, this case

can still be litigated. If you have any other questions with respect to this case, please contact Ronald B. Weinstock at FTS 566-3345.

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